Judges' Cognition and Market Order[1]

Benito ARRUÑADA*
Universitat Pompeu Fabra. Barcelona

Veneta ANDONOVA**
Universidad de los Andes. Bogotá

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Abstract

We argue that during the crystallization of common and civil law in the 19th century, the degree of discretion in judicial rulemaking, albeit influenced by the comparative advantages of both legislative and judicial rulemaking, was mainly determined by the anti-market biases of the judiciary. The different degrees of judicial discretion in both legal traditions were thus adapted to different circumstances, mainly the unique, market-friendly, evolutionary transition enjoyed by English common law as opposed to the revolutionary environment of the civil law. On the Continent, constraining judicial discretion was essential for enforcing freedom of contract and establishing a market economy. The long-term confluence of both branches of the Western legal system towards lesser freedom of contract is explained as a consequence of increased perceptions of exogenous risks and changes in the political system. These favored the adoption of sharing solutions that interfered with market-supporting institutions and removed the cognitive advantage of parliaments and political leaders.

Key words: judges, enforcement, history of legal systems, behavior, Evolutionary Psychology.

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* Department of Economics and Business, Universitat Pompeu Fabra. Mail: Ramon Trias Fargas, 25-27. 08005-Barcelona, Spain. E-mail: benito.arrunada@upf.edu.

** Department of Business, Universidad de los Andes. Mail: Carrera 1 No. 19-27. Edif. LA 2004. Bogotá, Colombia. E-mail: vandonov@uniandes.edu.co.

1. Introduction

Some recent studies claim that common law legal systems provide superior solutions to those developed in the civil law tradition.[2] We develop and examine an alternative hypothesis, grounded on judicial behavioral biases and self-selection, according to which both common and civil law supported a transition to the market economy adapted to local circumstances. In essence, we propose that the form of law be treated as a choice variable rather than an exogenous constraint. In particular, we argue that the extent of judicial discretion, seen by us as the main difference between the two legal systems, was constrained in civil law jurisdictions to protect, rather than limit, freedom of contract against a potential judicial backlash. This protection was unnecessary in England, where free-market relations enjoyed safer judicial ground mainly due to their relatively gradual evolution, their reliance on practitioners as judges and the earlier development of institutional checks and balances that supported private property rights.

We therefore build on the argument that both common law and civil law facilitated freedom of contract and were efficient in the 19th century, and that both became interventionist and potentially inefficient in the 20th century as a result of common causes (Rubin, 1982). We argue that both common law and civil law, specifically French civil law solutions, were well adapted to their particular circumstances, and we point out the cognitive roots of the changes experienced by both systems in the 20th century. Our focus is on cognitive failure or biases, which we argue are the key factor for the allocation of rulemaking power. One sort of cognitive failure occurs when decision makers (courts) are systematically biased towards considering interactions, conflicts, situations and even concepts of justice in a way that is ill adapted to a newly created context such as the market economy. This decision failure has therefore an "ecological" nature, as the rationality of decision makers is bounded not so much by constraints as because it is adapted to certain past environments. This cognitive argument provides a novel perspective on normative issues in the area of comparative institutional analysis, suggesting that the value of legal systems depends not only on their specific traits but also on good environmental fit. Our aim here is to identify the local circumstances that previously defined the balance of the

institutional trade-off and the forces that are shaping current tendencies, sharpening the self-selection argument we developed in Arruñada and Andonova (2005) in three ways: explaining the behavioral roots of the anti-market cognitive bias; examining the influence of this bias on the creation of common and civil law while emphasizing the unnaturalness of the market; and using the argument to explain the convergent, anti-market evolution of both legal systems in the 20th century.

The remainder of the article is organized as follows. In Section 2 we briefly discuss alternative mechanisms for allocating rulemaking power and state our hypothesis concerning the evolution of common and civil law. We argue that common law countries featured greater judicial discretion because, given their more gradual evolution away from the ancient regime, their institutional checks and balances and their reliance on practitioners for judicial positions, judges had a cognitive advantage for understanding the intricacies of market relations. Therefore, common law judges did not threaten the development of a modern market economy. Civil law reformers, in contrast, limited the discretion previously enjoyed by judges who were ill-cultured about the market, and placed more rulemaking in the hands of the legislature in an attempt to shelter free-market relations, especially freedom of contract, from judicial backlash, given the aversion of continental judges to capitalist wealth accumulation. Both of these policies, promulgating codes and reducing judges' discretion, shared the same goal, that of protecting freedom of contract and promoting market relations where previously they had been held up by mandatory rules and judicial regulation of private contracts. We then confirm the consistency of our argument by reviewing the relevant historical evidence. In doing so, we compare the acceptance of market relations in England relative to that in France instead of comparing both to some ideal set of rules that guarantee market friendliness. In particular, Section 3 analyzes the evolution of both legal traditions, emphasizing their divergence until the 19th century and their convergence in the 20th century. We argue that differences in judicial training first shaped the common tendency towards market-based relationships in England and on the Continent in very different ways. Later on, the convergence experienced during the 20th century was largely triggered by the democratization of political systems, which removed the cognitive advantages

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[2] Mainly, La Porta *et al*. (1997, 1998, 1999), Mahoney (2001), and Djankov *et al*. (2002, 2003).

previously enjoyed by political leaders. Section 4 concludes by examining some policy implications and emphasizing the importance of local circumstances for designing market institutions in transition and developing economies.

2. The allocation of rulemaking powers

The two key elements of a market-friendly legal environment are rules and courts. Rules, given by customs, previous judicial rulings and statutes, provide parties with a detailed default contract and also set the terms of trade when the law so mandates. Courts fill in the gaps in the contract and the received rules, define the terms of trade for all remaining unforeseen contingencies and provide last-resort enforcement of contractual agreements. Courts also perform rule-related functions: from merely enforcing statute law to creating and modifying rules. The presence of courts should therefore save on transaction costs for all parties.

2.1. Degrees of judicial discretion

We assume here that the main difference between legal systems hinges on the degree of rulemaking discretion enjoyed by courts.[3]

The idealized model of common law, as it finally emerged in the 19th century, presents greater discretion for courts, as statute law plays a minor role and each court is relatively free to rule, originally even with respect to precedent. In contrast, the civil law model, as crystallized more or less at the same time, gives priority to legislative rulemaking. Courts are instructed to

[3] Klerman and Mahoney (2007) show that the degree of centralization of justice does not correlate with the historical divergence of the legal systems, as argued by Glaeser and Shleifer (2002). Therefore, without loss of generality we can focus on the rulemaking authority enjoyed by the judicial system instead of analyzing its interplay with the degree of decentralization of judicial powers.

enforce the received law and, even for filling gaps in rules and contracts, lower-level courts have to comply with the jurisprudence created by higher courts.[4]

All kinds of rulemaking systems are likely to suffer inefficiencies as a consequence of participants' self-interest and cognition. Both legislatures and judges may fail to achieve the public good because they pursue private interests or, even when pursuing the public good, they fail to ascertain which rules are most suitable. We will argue that, in the development of the Western legal system, cognitive failures more than any other factor determine the degree of judicial rulemaking. In our understanding, differences in costs and benefits associated with self-interest were secondary or required a cognitive failure to become relevant.[5]

2.2. Ecological rationality: The unnaturalness of markets

Our focus is therefore on cognitive failure, which we assume is the key factor for the allocation of rulemaking power. In particular, courts may be systematically biased towards considering interactions, conflicts, situations and even concepts of justice in a way that is well adapted to the ancestral world of sporadic and simple interactions but not to market interactions. Take, for example, the case of a judge who believes to be "fair" for an individual case favoring the weaker party despite contractual obligations. As a result, he will harm all weak parties to future contracts, who will end up paying higher prices or will be unable to contract. A more comprehensive explanation of this decision failure can be given in terms of "ecological" rationality (Simon, 1956; Tooby and Cosmides, 1992; Gigerenzer et al., 1999), which is bounded not so much by constraints as because it is adapted to certain environments: first, to our common

[4] The different scope in the rulemaking capacity of the judge is not affected by the fact that even the ideal models of the 19th century share many other features. For instance, in both models, courts form a hierarchy, and superior courts can overrule decisions from lower courts, which in any case have substantial capacity for interpretation, as is evident from the fact the US appellate courts defer broadly to the trial judge's and jury's findings of fact (Posner, 1998: 584-586). The presence of these common characteristics should not obscure the existence of a basic difference in the extent of judges' rulemaking discretion.

[5] For a more detailed account of the role of self-interest, lack of information and bounded rationality for the degree of judicial rulemaking, see Arruñada and Andonova (forthcoming).

ancestral "environment of evolutionary adaptedness" (Bowlby, 1969; Barkow, Cosmides and Tooby, 1992; Crawford, 1998) and, second, with more malleable consequences, to our learning environment.[6] Therefore, when dealing with market interactions, even benevolent rulemakers may systematically rule against their own true goals because their myopic solutions were adaptive in our evolutionary past but are no longer adaptive in our current environment.

In particular, given that, in the evolutionary time scale, market relations are very new, they tend to be systematically misunderstood by judges poorly cultured in the market, leading to misguided justice. Findings in evolutionary psychology support that these failures may respond to instinctive human traits being applied out of context.[7] For example, in times of increased uncertainty when demand for collective insurance is high, biased judges might tend to provide social insurance instinctively, thus transgressing on fundamental market institutions, such as property rights or private contracts. If markets maximize social welfare, such behavior is economically detrimental to *all* economic participants and as a consequence cannot be explained by a simple self-interest or capture argument. In addition, cognitive failure has been argued to preclude market transactions even in an experiment in which these transactions not only maximize social surplus but also distribute it more equally (Arruñada and Casari, 2007).

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[6] The importance of biases documented by experimental psychology and economics has been questioned because experiments may fail to face decision-makers with relevant situations, oversimplifying the informational structure of real problems. See Cosmides and Tooby (1996), Gigerenzer and Goldstein (1996), Koehler (1996) and the works in Gigerenzer *et al*. (1999). The usefulness of evolutionary psychology in legal analysis has also been criticized by Rachlinski (2001), Ulen (2001) and Korobkin (2001), the main point being its inability to produce univocal predictions. See Jones (2001) for a defense of evolutionary psychology, as well as Korobkin (2001) for a much-needed integrative view that defends combining rational choice and evolutionary psychology with empirical analysis in a multi-disciplinary enterprise. For a summary, see Arruñada (forthcoming).

[7] See Fiske (1991) and Cosmides and Tooby (1992). These findings provide a common and more solid ground to the pioneering and rival arguments by Polanyi (1944) on the limits of market-type relations and the resistance of societies to the dominance of such relations; and, mainly, Hayek (1944, 1960, 1973-1976, 1988) on the opposing rules of the "extended order of cooperation through markets" and the more intimate and personal order. The evolutionary argument helps in explaining both the difficulties for "disembedding" the economy, in Polanyi's terms, and the tendency to apply personal rules to the market order, in those of Hayek. The danger that the primitive collectivistic leanings of human beings pose to the market has also been stressed by Smith (2003) from the perspective of experimental economics.

In essence, judicial proclivity to redistributive justice and to balanced compensation fits in neatly with the prevalent role that sharing, authority and reciprocity have arguably played in most human interaction during our ancestral environment that was characterized by simple, infrequent (barter) exchanges between related parties (Fiske, 1991; Cosmides and Tooby, 1992). The apparent disregard that some judges show for the future effect of their rulings on later trade seems also adapted to the ancestral environment in which trade was only made on the basis of reciprocity and most interactions took place among relatives and personal contacts. This probably causes a bias in favor of identifiable individuals and against anonymous parties,[8] a bias which is also likely to be damaging to judicial rulings. Such biases are more serious when an element of abstraction is present in the transaction because human brains, in contrast to their more intuitive understanding of barter of physical goods, show intuitive resistance to grasping the value added by providers in abstract transactions, mainly those which involve intangible services and inter-temporal exchange, such as the use of capital and payment of interest, elusive services such as mediation and arbitrage and also services provided by human capital that has been created through previous and therefore now invisible investments, like professional services. Not by chance, all these trades have historically been among the first to be restricted or forbidden. More recently, the judicial apprehension against adhesion contracts can be traced to the same cause, if we think of the different treatment that courts give to such contracts and to physical products, even though both are complex designs produced by competitive firms. As Manne (1997: 34) pointed out, judges are willing to void a clause because the buyer does not understand it but they do not cease enforcing the purchase of a car because the buyer does not understand its engineering.

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[8] Favoring people we know is consistent with findings that people faced with cooperation games cooperate more when they are allowed to communicate than when they play against anonymous parties (Dawes, McTavish and Shaklee, 1977; Isaac, McCue and Plott, 1985; Isaac and Walker, 1988; Valley *et al.*, 2002), even for one-shot interactions and especially as communication opportunities increase (Ostrom, Walker, and Gardner, 1992). In addition to this bias, probably rooted in mental mechanisms which evolved to facilitate cooperation, human beings have been shown to find it very difficult to make more than a few cycles of mental inferences in experimental settings (Nagel, 1995; Camerer, Ho and Chong, 2003). This difficulty could hinder the full evaluation of rulings that affect market transactions, given that markets act through long series of overlapping effects, as argued by Arruñada and Casari (2007).

This argument fits in well with the tendency for disregarding the log-run systemic effect of judicial rulings on market relations. If, for example, a ruling in an insolvency case considers the debtor's poverty, it might resolve an individual problem but, to the extent that it prevents creditors from collecting their debts, it hinders all loans that might be subject to similar rulings in the future. As a result, the ruling also harms anonymous potential debtors of a similar type to the beneficiary of the judgment, who are deprived of access to credit or will have to pay additional interest. In a similar vein, the substitution of unjust dismissal doctrines for employment at will in several US states has been found to have damaged new workers in those states causing, among other consequences, significant increases in temporary aid (Miles, 2000; Autor, 2003). The argument is also applicable to courts' bias against the exercise of quasi-judicial decision rights by the parties, even when the parties themselves have explicitly contracted for these quasi-judicial rights ex ante. Such an arrangement is often efficient when one of the parties has the best information and incentives to carry out such a judicial task because of its central position and reputation.[9] This quasi-judicial activity, crucial when controlling a network of producers, is undermined in court when judges interpret the subject matter of litigation as deriving from greater bargaining power on the part of the larger party and not from the ex post exercise of judicial functions that were contractually allocated ex ante by the parties. Such ex post contractual asymmetry tends to be perceived by judges in different countries as unfair and they therefore tend to correct it, thus inefficiently restricting the quasi-judicial powers which the private contract itself allocates to one of the parties and leading the parties to introduce additional clauses with the purpose of avoiding judicial intervention (Masten and Snyder, 1993).

[9] This explains why car manufacturers are assigned rights in relation to their dealers to define their obligations, assess their performance and punish or reward them accordingly (Arruñada, Garicano and Vázquez, 2001). Many retailers carry out similar quasi-judicial functions with respect to their suppliers (Arruñada, 2000).

In sum, when insufficiently *cultured about the market*,[10] judges keep sentencing as if they were living in a non-market economy in which transactions are relatively unique, concrete, reciprocal and spot events, in which no credit element is involved or systemic consequences expected.[11] Do legislators also suffer this anti-market bias to a similar extent? For some issues, like those related to identification of individuals, it is clear they do not, because the legislature generally rules in more abstract terms and for anonymous parties, at least in private law, and not with respect to specific cases, while judges have personal contact with the parties. As a consequence, it is more difficult for judges than for legislators to see beyond the individual case into the systemic consequences that rulemaking imprints on market relations. However, this supposed advantage of legislators would affect all legal systems equally and cannot therefore explain the discrepancy in judicial discretion between common and civil law.

Furthermore, for most issues, legislatures are quite willing to follow redistributive policies, abrogating contracts if necessary, as often occurred in history with debt contracts.[12] In general, the existence of a cognitive gap in favor of the legislature hinges on the structure of the political system. We maintain that legislators did not suffer a similar anti-market myopia in Continental Europe in the 19th century, resulting in a cognitive gap between legislators and judges, because the political system left the government in the hands of intellectual elites who could contemplate the profit opportunities brought about by economic change, while the old continental judiciary was still staffed by a sort of nobility raised and anchored in the ancient regime. This is highly visible in the function of parliaments which, at the time, were considered the finders of the true and rational solution—the "law." The intention was that the law should endure and be applied

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[10] Two remarks are in order. First, the "culturalization" that we refer to is linked to an understanding of how the market works and has no necessary connection to the amount of formal training. Second, judges are influenced by cultural factors, such as their education and religion, but these cultural influences always operate on a biological basis, which is constrained by our ancestral environment. See Barkow, Cosmides and Tooby (1992), and, for introduction and updated references, Cosmides and Tooby (1994) and Pinker (1997, 2002).

[11] Our emphasis on judicial biases complements recent applications of evolutionary psychology to legal theory, most of which focus on how the law interacts with evolved minds considered as, for instance, citizens, holders of liability, contractual parties or criminals (see, for example, Jones [1997] and, for extensive references, Jones [2001: 209]).

universally. In contrast, parliaments evolved in the 20th century as weighing machines or battlegrounds that establish equilibriums amongst private interests, and produce mere "rules" according to the momentary prevailing consensus, with no pretence of permanence and often in violation of freedom and equality as both concepts were previously understood.[13]

2.3. Hypothesis: The pro-market orientation of the Western legal system

The assumptions behind our analysis of judicial rulemaking discretion are equivalent to assuming that the legislator wants to create a market economy.[14] Historically, market institutions were created in a more spontaneous manner in common law, while in civil law they were subject to a greater degree of intervention by the builders of the liberal state in the 19th century and can therefore be treated as decision variables. In analyzing civil law, we can personalize these state builders who wanted to create a market economy, whereas in common law we have to assume the existence of a fictional social planner. The difference is not substantive, however.[15]

In this framework, the legislator will allocate rulemaking discretion to the judiciary considering the specific circumstances in each country. In particular, legislators creating market institutions may restrain judicial rulemaking to avoid judges' opposition to freedom of contract and market exchange by compulsorily subjecting the judge to the law and thus guaranteeing the

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[12] An example is the farm foreclosure moratorium legislated in the USA in the 1930s, upheld by the Supreme Court in 1934 (Alston, 1984).

[13] This process is described, if not explained, by Schmitt (1936), and is now often seen as an exaggeration of democracy to the detriment of liberty (for instance, Zakaria, 2003). In particular, see also how, for England, law was something to be "deduced," not to be "created" before the Reform Act of 1832 (Pipes, 1999: 127).

[14] Assuming intentionality of the legislature in the design of the judicial system is justified. Klerman and Mahoney (2005) argue that before the late 17th century English judges were servants of the king. After the Glorious Revolution, the degree of independence of the English judiciary was determined by the interplay of interests of the Parliament and the Crown's Parliamentary allies.

[15] Furthermore, the difference should not be exaggerated, as the members of the English House of Commons at the time of William III have been declared "the legislative supporters of secure property rights" (Klerman and Mahoney, 2005), making evident the need for legislative legitimization of the institution of secure property in England.

enforceability of private contracts. From this perspective, both Western legal systems might therefore be understood as adaptations to specific conditions that allow the development of effective market-supporting institutions in different historical circumstances, where judicial comprehension of market exchange alters the desirability for more or less judicial rulemaking authority.

Market relations were introduced sooner in England, as many feudal constraints were abrogated earlier and the industrial revolution took hold earlier. These changes also took place more slowly than on the Continent, without such drastic changes in property rights. This creeping evolutionary process, together with a generalized respect of private property, gave time for judges and the public to be cultured in an intellectual tradition that had become more propitious to the free market. In most of Continental Europe, however, most of the constraints that the ancient regime imposed on trade and movement of land and people were suppressed later and more abruptly, often together with substantial redistribution of property. Most judges were then still the intellectual product of the ancient regime, in addition to forming part of the former ruling elite. Their lack of understanding of the market and disrespect for property rights and capitalist wealth accumulation explain why the defenders of contractual freedom responsible for designing the institutions for continental markets opted for constraining judicial discretion.[16] From this perspective, we explain the restrictions imposed on judges in the civil law tradition, whereby they had to subject their rulings to contractual terms (whether defined explicitly by the parties or tacitly by default through statute law and jurisprudence) as an institutional control designed to protect an unnatural creation—market contracting—from our ancestral instincts.

[16] It is possible that judicial discretion was to a certain extent already limited in the Roman law tradition from the 12th century but this did not prevent later evolution from *additionally* constraining judges' discretion.

3. A historical overview

Our argument is broadly consistent with the history of both legal traditions. We first confirm that institutional checks and balances and judicial training shaped the common tendency towards market-based relationships in England and on the Continent in very different ways. Second, we describe the convergence of Western legal traditions during the 20th century as a restoration of instinctive social patterns. We argue that these are made possible by the democratization of the political system, which removed the cognitive advantage of parliaments and political leaders in protecting market institutions.

3.1. The evolution of common law and its judiciary

The evolution of common law was shaped by the judges who coined most of its rules. The appointment of English judgeships was dependant to a much greater extent than elsewhere in Europe on professional practice, as English judges were chosen from among barristers. As such, they had seen the world from the perspective of the parties they had represented and were therefore more familiar and educated about the systemic effects of the incipient market exchanges (Duman, 1982: 29; Abbott and Pendlebury, 1993). The understanding by English judges of the fundamentals of the market economy also benefited from the early checks imposed on royal authority which, by limiting the ability of the Crown to sell new public offices (Swart, 1980), gave judges the ownership of secure investments (the judgeships), in addition to creating an environment of general respect for private property (North, 1981; North and Weingast, 1989).[17] As a result, the transformation of the feudal economy spurred on by Parliament received

[17] For some historians, this view exaggerates the role of the English Parliament in creating a market-friendly institutional environment (for example, Carruthers, 1990; Clark, 1996; Epstein, 2000). This criticism, however, does not question the fundamental point that the English Parliament exerted much greater control over the Crown. In a similar vein, there were also some well-developed markets on the Continent, specifically credit markets (for instance, Hoffmann, Postel-Vinay and Rosenthal, 2001). When considering these markets, the dominance of agriculture in the economies of the 16th to 18th centuries should be kept in mind, however, as well as the likely fact that market relations for trade in goods had been well-established in some areas of the Continent earlier than in England, as shown by the history of

an early ally in the English judiciary which, by making incremental changes in long-standing customs, supported the evolutionary development of common law toward the new market order. This judicial proclivity to defending private property and freedom of contract during the seventeenth century seems to be wildly acknowledged even though the reasons for it are still open to debate.[18]

The Industrial Revolution brought about larger potential markets, which required more developed and uniform rules. Common law satisfied these demands during the 19th century, mainly by introducing some well-tested, Roman law solutions,[19] and strengthening the doctrine of binding precedent, by which courts are reluctant to interfere with principles established in previous decisions (*stare decisis*). Despite these changes, however, the way common law sustained market institutions remained evolutionary in nature because, first, the introduction of Roman law took place mainly at the level of concepts, as codification attempts did not succeed, arguably because they were less necessary than on the Continent.[20] Moreover, the legal development of common law, which supported the huge economic development of the 19th century, remained almost exclusively the work of courts, with few legislative initiatives. Second, the strengthening of the doctrine of binding precedent did not divert common law from its evolutionary path, as precedents could still be overturned with relative ease by distinguishing the

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Italian cities in the Middle Ages, the Hanseatic League or the Champagne fairs. This also applies, in particular, for ascertaining the importance of merchant law. The challenge for those creating the institutions of the modern market was to develop institutions not only for trade but, perhaps, mainly for transactions among non-merchants.

[18] See Klerman and Mahoney (2005) who emphasize "judges' concerns for their reputations, the interest of the legal profession as a whole, and the large property holdings of the judges themselves." In fact, the model of 18th century common law (judge-made law) has been the paradigm of market efficiency and freedom of contract according to many authors in the law an economics literature. As a result, judge-made law was established as the standard against which other legal systems are compared.

[19] For this, we rely on Zywicki (2003), who, by citing other authors, suggests that "excuse doctrines such as impossibility and frustration" have Roman law origins and that they were introduced into the English contract law (Law Merchant). These doctrines permeated the common law when the Law Merchant became fully integrated into the system of common law in the late 18th and early 19th centuries.

[20] This divergence in codification is consistent with the argument that Continental codification was driven by the need to constrain judges, rather than to systematize the law, which probably was as unsystematic in England as on the Continent.

case at hand from the one in the precedent.[21] Together with the right of appeal,[22] it was, however, important in ensuring consistency and equality across increasingly wider markets (Manne, 1997: 13-19).

3.2. The conscious design of modern civil law

The development of the law on the Continent followed a different path, largely because of the way judges were selected and trained. Not only were they appointed without previous practice (Doyle, 1996) but their training was based on the university study of *ius commune*, a doctrinal system developed mainly by scholars proficient in Roman and Canon law, and only secondarily affected by statutes and judicial rulemaking. It has been claimed that both the lack of practice and these doctrinal influences made Continental judges more resistant to capitalist wealth accumulation and hindered their understanding of market transactions. Although judges in the higher courts were generally recruited from the ranks of the most eminent practicing lawyers (Gorla and Moccia, 1981), French judges, for example, like other nobles under the ancient regime, received their income from land, urban property, venal office and annuities. Furthermore, they despised the considerable risk exposure of merchants, merchant manufacturers and bankers whose sources of income were incompatible with the nobility status (Bluche, 1960). In fact, it has been widely acknowledged that French magistrates sacrificed capital for status (Taylor, 1967). Judicial respect for property rights also probably suffered because judgeships were often expropriated by kings who were free to sell new judicial offices (Doyle, 1996; Swart, 1980) and interfere with private property (North and Thomas, 1988; Pipes, 1999), hampering the secure development of property rights. Thus, the judiciary on the Continent did not gradually erode the constraints of the ancient regime. On the contrary, civil law judges hindered the

[21] The demand for more binding precedents during the 19th century is understandable, because of the greater geographical scope of the market, triggered by better transportation technologies (canals, rail, steamships) which probably required faster adoption of legal standards over a wider area.

[22] The right of appeal was very limited in England before the mid-19th century (Baker, 2002). We thank an anonymous reviewer for making us aware of this point.

development of new market order, for both political and cognitive reasons. A radical change in both the law and the administration of justice was therefore necessary.[23]

Consequently, the new legal order was implemented in a top-down fashion even if it was essentially a liberal (that is, free-market-enhancing) initiative. Legislators issuing Civil and Commercial Codes in the 19th century aimed at both systematizing custom and case law, mainly through default rules, and mandatorily regulating what we would now call externalities. Their reliance on case law led to the codification of well-tried default rules, when available, allowing parties to adapt contracts freely to their circumstances by writing specific clauses into them. As a result, 19th century codified law was mainly the distillation of customary law, and codes represented a combination of local customs, local laws and subsidiary Roman law (Sirks, 1998) and had a predominantly default nature.[24]

In addition, most mandatory rules enacted at the time had a clear function in grounding the market economy. Some of the most important of these mandatory rules are a direct consequence of the political principles of freedom and equality, which have contractual correlates in terms of mandatory freedom of contract and mandatory equality of all contractual parties.[25] In contrast, previous law often granted higher probative status to the word of employers than to that of employees. Market support was also behind the emphasis of liberal reforms on precluding the future entail of property, thus facilitating the emergence of a proper market for land.[26] Property law provides another interesting case in its treatment of a particular kind of externalities, those caused in the ancient regime by the proliferation of property rights and their enforcement as

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[23] The only exception the French revolutionaries made was in respecting the commercial courts, arguably because their members were elected (Tallon, 1983).

[24] In particular, codifiers of commercial law, from the Code Savary in 1673 to the Uniform Commercial Code of 1970, relied heavily on the *lex mercatoria*, developed by merchant courts (Benson, 1998).

[25] In the Decree of September 20 1869, establishing the bases for the Commercial Code of Spain the legislator states that "The new formula is clear, precise, blunt: the legal rule of any transaction is that provided by the free will of the parties: it must be what the contracting parties have wanted it to be: they remain obliged to those who have wanted to be obliged, whatever the form."

[26] Notice that, by the 17th century, common law had already developed the Rule Against Perpetuities, which enabled a court to declare void future or postponed interests in property that might possibly vest outside a certain perpetuity period. The goal seemingly was also to prevent land being tied up and to protect free markets.

rights *in rem* even when they remained hidden to third parties. During the 19th century, land law reform and the creation of land registers led to a stricter policy of *numerus clausus* in most European countries—that is, the legal system reduced the number of rights that could be enforced *in rem*, enforcing the rest as mere personal (in other words, contractual) rights. In parallel, publicity was increasingly required to produce rights enforceable *in rem*. Both of these constraints seem to diminish parties' freedom to produce rights *in rem* but in fact are essential for making some of them possible, reducing transaction costs in land and, in particular, making it possible to use land as collateral for credit (Arruñada, 2003), precisely the declared purpose of the reforms in this area.

Something similar happened with bankruptcy statutes which established the rules and the administration of post-default problems. The negative externalities caused by bankruptcy created severe problems for the development of the market economy when responsible central banks did not exist. In the 1808 *Code de commerce* enacted by Napoleon, most discretionary instruments that had allowed judges to offer debt moratoria to distressed agents were shed, and the procedural rules applying to the negotiation of concordats (agreements for financial and industrial restructuring) were considerably strengthened (Sgard, 2007)).

Furthermore, operationally, civil law bound the judge to the law. This has often been seen only as a tool to enforce state law, disregarding the fact that, when the law sets default rules, it protects freedom of contract by ensuring that the judge is constrained by the will of the parties. The law thus protected the private legal order freely created by the parties whereas, under a system of greater judicial discretion, this private legal order remains in danger.[27] This fear was behind the efforts made by 19th-century legislators to purge many dogmatic rules from received

[27] We do not consider private legal order solutions (of the type analyzed, for instance in Benson, 1989; Ellickson, 1991; Milgrom, North and Weingast, 1990; Bernstein, 1992, 1996, 2001; Greif, Milgrom and Weingast, 1994; Shavell, 1995), as we believe intrinsic difficulties prevent them from becoming the legal order for a modern capitalist economy. First, because the reliance of private enforcement on group membership limits its effectiveness to intra-industry trade, often on a personal level. Second, because they are only effective when state judges abstain from acting as appellate courts, which is always a possibility. Otherwise, private enforcement is only based on informal social sanctions, thus stressing its personal nature. This was particularly the case with merchant courts which, being subordinate to royal courts for appeals and enforcement, can be seen as mere local courts with an additional functional specialization.

law, often rooted in Canon law, that were contrary to freedom of contract. A prominent example is the liberalization of credit transactions, which were still subject to substantial constraints, including the prohibition of interest and foreclosure.[28] The exception confirms the rule here, as in England foreclosure was limited by the Chancery court, which was the one that most resembled a French court, where judges were trained in Canon law (Klerman and Mahoney, 2007). Similarly, reformers often prohibited the judge from reducing the sum involved in the penal clauses established contractually to punish a debtor in default (Danet, 2002: 218). Most codes also derogated rules that had allowed courts to disregard some "unequal" contractual clauses on the basis of scholastic "just price" arguments, such as the doctrine of "lesion."[29] More importantly, the scope of "cause" as a necessary element of any enforceable contract was considerably reduced (by reversing the burden of proof, for instance), and even fully eliminated in the "abstract" transaction of the German civil code as well as, more generally, in the laws of mortgages and bills of exchange. This pruning of the concept of cause curtailed the possibility of constraining contractual freedom with moral principles that the canonist interpretation of the original Roman concept had previously offered.

Understandably, reformers also sheltered legal reform from any judicial reaction, including the possibility that judges would exert their discretion to decide on the basis of abstract principles and against the new rules,[30] thus rendering the reform ineffective and hindering

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[28] For example, until the 18th century, French laws against usury outlawed short-term credits that were indispensable for commerce, industry and banking. Borrowers and debtors therefore had to spend substantially on circumventing the prohibition, which hindered the development of the financial market (Taylor, 1967: 480). Understandably, one of the main goals of the Napoleonic Code was to empower contractual parties to act on their own behalf, protecting them from anybody, including judges, who might alter the terms of their agreement (Mattei, 1997).

[29] Ascribing the doctrine of lesion to "the civil law," without warning of its removal or reduction by 19th century codifiers (as done, for example, by Cooter and Ulen, 1997: 191, 253), exemplifies the ambiguities that complicate comparisons between legal systems. See, for a detailed analysis, Abril Campoy (2003: 42-70).

[30] For example, Hayek (1960), among many others, emphasizes that the revolutionaries distrusted judges, and their desire to control judicial discretion led them both to issue codes and to adopt more formalized legal procedures. This is consistent with recent empirical evidence showing that civil law countries regulate the judicial process more thoroughly (Djankov *et al.*, 2003).

development towards the market order. Legislators therefore subordinated the judiciary to the law and to jurisprudence, and restructured the professional career of judges.

Not only were codes and statutes given priority as a source of law, but the production of binding precedents was allocated to the higher court of appeals, which was conceived, at least originally, more as a court-controlling body than as a proper court. Its function was to supervise the legal interpretations given by lower courts, guaranteeing uniformity, making judicial decisions predictable and enhancing legal security. Furthermore, no court had powers to question the constitutionality of legislation. In the French model, even controlling the executive power was assigned to a quasi-governmental judicial body, the Conseil d'État.

In parallel, the practice of purchasing judicial offices was abolished and judges were converted into civil servants. They started their judicial career young and inexperienced, by passing specific exams after law school. Even today their promotions and salaries increase with seniority and sometimes with discretionary governmental appointments to the higher courts and other public offices (Hadfield, 2007). This meant that judges could lose substantial quasi-rents if they opposed the government or, even worse, were expelled from their positions. Compliance was further enhanced in some countries by modifying judicial liability, making judges personally liable if they decide contrary, not to dominant doctrinal opinion, as before, but to the statute law and formally established jurisprudence.

Summing up, our interpretation as to why reformers in civil law countries reduced the discretion of the judiciary is that, in such countries, the transition to market economies was relatively more revolutionary, was generally not supported by ancient regime judges, while judges cultured about the market were not immediately available. Therefore, on the Continent liberal reformers could not have chosen to maintain greater judicial rulemaking authority while changing the method of judicial selection because all jurists were educated in the same dogmatic legal tradition. Institutional change in England followed a relatively smooth, evolutionary process, which started much earlier and developed over a considerable time span, giving time and occasion for the judiciary to become cultured in the market order. In contrast, judiciaries in Continental Europe were structured with greater central control with a view to achieving and enforcing an intended change, for which judges were largely unprepared.

3.3. Current anti-market trends in the Western legal system

Both common and civil law suffered substantial transformations during the 20th century, such that jurisdictions pertaining to different legal traditions now show remarkable similarities in areas in which they are often assumed to differ. Considerable convergence has also taken place in fields in which legislation is more recent, such as consumer protection or financial regulation. These changes have been interpreted as consequences of a general social shift from a more individualistic economic and social order to a new kind of collectivism (Berman, 1983: 34; Merryman, 1985: 14). This shift is consistent with an interpretation based on our hypothesis because the political structure required in both systems experienced radical changes.

As we will see, changes in the structure of the political system at the end of the 19th century and the beginning of the 20th, such as the introduction of universal suffrage and the development of organized interest groups—from big firms to unions, moved most countries away from an elitist model of democracy, thus introducing anti-market biases into the rulemaking institutions, which previous governing elites had learned to suppress. Whatever the direction of causality, however, the cognitive gap between legislators and judges with respect to anti-market biases was likely to diminish substantially or even disappear as a consequence of the change in the political system that transformed political leaders into political agents.[31] Political systems consequently became willing to supply a certain amount of "sharing" solutions, even if they were contrary to freedom of contract, the market order and long-term economic prosperity.

In addition, changes in the legal system might have satisfied an instinctive demand for insurance at a time when the political system was more willing to supply it. From the perspective of evolutionary psychology and mainstream economics (Rodrik, 1997), the high level of insecurity and, mainly, the exogenous risks generated by the two World Wars, the Great Depression and more recently globalization, activated demand for "sharing" solutions, introducing all sorts of welfare mechanisms and creating the mixed-economy systems that have characterized Western societies since the second part of the 20th century. (Even if the antecedents

[31] For an account that considers the potential influence of evolutionary maladaptation in politics, see Rubin (2001a; 2001b; 2002: 153-181).

of the welfare state go back to the fourth quarter of the 19th century, they did not reach a substantial share of GDP until well into the 20th century. The weight of the state in the economy also differs substantially across countries but today's cross-country differences are much smaller than historical differences between the present and the 19th century). Evolutionary anthropology tells us that, historically, human beings relied on social sharing structures for coping with exogenous risks.[32] Understandably, the World Wars and the Great Depression might have triggered a backlash against the free functioning of the market and the introduction of all sorts of state controls and social insurance, and this conjecture finds some support in the parallel events that took place almost simultaneously in countries under civil and common law, with interventionist rules substantially constraining freedom of contract in both systems. This does not imply that the 20th-century solution, characterized by constrained freedom and redistribution, is poorly adapted. On the contrary, these economies have been successful in terms of sustained growth rates and social stability. Furthermore, some experimental works support the claim that competitive interaction among humans requires some degree of redistribution to be stable.

3.3.1. Changes in Common Law

We argue that the introduction of universal suffrage, the increase in perceived uncertainty and the rising demands for social insurance described above are behind the changes in the fabric of American common law, which was substantially altered by decisions taken by both legislators and judges.

At the legislative level, the "New Deal" of the 1930s marked a radical turning point,[33] moving away from the principles of freedom of contract, introducing wide-ranging regulation and administrative oversight of many private economic activities, affecting contractual and property rights, and developing an enormous body of administrative law. It brought extensive

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[32] See Cashdan (1980, 1989), Kaplan and Hill (1985), Kaplan, Hill and Hurtado (1990), Cosmides and Tooby (1992).

[33] See Calabresi, 1982; Sunstein, 1989; Manne, 1997; Glaeser and Shleifer, 2001; and, for a more nuanced perspective emphasizing earlier social legislation at the state level, Scheiber (1998).

mandatory legislation in fields of law that had hardly existed before, such as labor relations, securities, public housing, social security and environmental protection (Berman, 1983: 34).

The New Deal was also a defining moment for the United States' Supreme Court, whose will was twisted to endorse the constitutionality of the New Deal package. Crucial elements of the Constitution were reinterpreted, reducing individuals' freedom of contract in many areas, from labor relations to the issuance of financial securities.[34] Consequently, it lost some of its authority as a guardian of the Constitution together with much of its capacity to override the interpretation of regulations issued by governmental agencies. Courts were able to impose procedural restrictions on administrative agencies but were prevented from achieving substantive results (Manne, 1997: 24).

In addition, judicial interpretation, which for centuries had been supportive of freedom of contract, started to constrain it.[35] This happened, for example, with respect to product liability in the US after *MacPherson v. Buick Motor Co.* in 1916 and *Henningsen v. Bloomfield Motors, Inc.* in 1960 (Benson, 1998: 92) and the application of so-called "enterprise liability," making manufacturers absolutely liable for all accidents arising from the use of their products (Priest, 1985), a practice that allegedly motivates carelessness by consumers. With similar dubious arguments of market power, inequality and unfairness, since the *Williams v. Walker-Thomas Furniture Co.* case of 1965, some US courts have also been applying the doctrine of "unconscionability," refusing to enforce clauses that offend the courts' conscience and coming, in the broadest interpretation of the doctrine, amazingly close to using raw versions of the scholastic arguments of Canon law. Something similar is happening in labor law with the

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[34] Even though the Supreme Court had always reinterpreted constitutional provisions in the context of contemporary society and authors disagree on the degree of discontinuity caused by the New Deal legislation on constitutional jurisprudence (Epstein, 1985; Cushman, 1998), sentences on New Deal legislation marked a turning point for key dimensions of the market legal order, such as the debasement of freedom of contract, the subordination of private property and the expansion of government regulatory authority.

[35] Manne (1997: 20-29) summarizes this as parallel change in legal doctrine and education, with the breakdown of the Austinian model, which is extremely respectful of precedent, and its substitution for Legal Realism in the first part of the 20th century.

tendency of common law courts to require employers to show "just cause" when terminating a contract that includes the default clause of termination at will (Schanzenbach, 2003).

3.3.2. Changes in Civil Law

Civil law experienced similar changes with only minor differences in timing and intensity. In the legislative area, changes were frequent mainly as from the 1920s,[36] when corporatism with diverse political agendas but a common anti-market flavor gained power in several European countries and, with it, state intervention grew in all kinds of private activities. Parliaments, transformed from discoverers of permanent law into representations of heterogeneous private interests (Schmitt, 1936), now enacted plenty of transient and mandatory rules in new legislation, in fields similar to those of the New Deal, a process only reinforced after World War II with the extension of welfare states. Mandatory legislative intervention in old codified law, in the fields of contracts and property, was initially limited, exploding only in the 1960s and 1970s. This greater legislative activity converted what was once thought to be a coherent whole into a mass of ad hoc, and frequently contradictory, rules (Berman, 1983: 35-38).[37]

It might be argued that changes against freedom of contract in civil law countries were made easier because these countries entered the 20th century with more powerful legislatures, unconstrained by the rulemaking capacity of the common law judiciary. Comparing end results in Europe and the US seems to confirm this interpretation, because interventionism grew more in Europe. The British case, however, casts some doubts. It illustrates, first, that common law is not sheltered against heavy socialization and, second, that a strong legislative power may be the right tool for reinvigorating the market, especially when the relatively discretionary but unsophisticated judiciary is empowered to rule out freedom of contract in common law countries by means of judicial activism.

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[36] The second wave of codification, which started with the 20th century, is also often considered much less pro-market than the first wave—for instance, in the treatment of "lesion" (Abril Campoy, 2003: 48-53).

[37] A similar change arguably occurred in non-European civil law jurisdictions. For a detailed account of the evolution of political system and creditor rights in Brazil (1850-2003), see Musacchio (2008).

In addition, in many civil law jurisdictions, changes in the position of judges have increased their rulemaking powers. First, control of civil law judges has been relaxed and they now enjoy more freedom. Some of the constraints existing in the 19th century, among them personal liability, have also been lifted. Moreover, judicial congestion partly frees judges from the implicit control of appeals, which have become much more costly because delays have increased in parallel with a growing opportunity cost of time. Lastly, the above-mentioned change in the nature of parliament has explicitly enhanced the position of judges, especially when constitutions safeguard the positive rights of some groups (civil servants, churches, unions, etc.), constraining legislative discretion (Schmitt, 1936).[38] This is clearer with respect to constitutional courts, which were designed to control the legislature and whose powers were reinforced after the second World War.[39] But lower-level courts now also enjoy greater discretion in some jurisdictions, in which they can now start proceedings at the constitutional court by questioning the constitutionality of legislation. Similarly, within the European Union, lower courts can also initiate a similar proceeding at the European Court of Justice when they understand that national law contradicts EU law. If our cognitive argument on judicial failure is correct, this greater discretion of civil law courts will probably be used to constrain freedom of contract, unless judges gain a better understanding of market mechanisms.

4. Final remarks

We end by summarizing our analysis and presenting some policy considerations, which are pertinent for the unsolved problem of how to build market institutions in transition and developing economies.

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[38] It also modifies the function of "judicial review" (the power of courts to declare legislation void because it violates the constitution) which, instead of being a safeguard of freedom, ends up constraining it.

[39] See Alexy (1993) for a theory about the role of the constitutional court in controlling legislation that might reduce the protection of rights by the state.

We have argued that the initial evolution of both common and civil law was instrumental in protecting freedom of contract and developing market economies. We have also explained the different degrees of discretion granted to courts in both systems as adaptations to particular circumstances, especially to the availability of judges favorable to the market in England and the lack of such judges on the Continent. In our analysis, greater judicial discretion in classic common law courts therefore emerges more as a historical and possibly unique exception than as a replicable solution.

Recent studies comparing the performance of common law and civil law traditions (La Porta *et al*., 1997, 1998, 1999; Mahoney, 2001; Djankov *et al*., 2002, 2003) seem to focus on relevant, but relatively minor, issues. They fail to distinguish causalities from correlations or to recognize the fact that performances are observed only for those choices that were actually made, while the relevant comparison would be between the chosen option and its unobserved alternative. Such comparative analyses therefore provide shaky grounds for policy recommendations. This may explain the recurrent paradox that, even though these empirical comparisons support the claim that common law is superior to civil law for the development of financial markets (e.g., La Porta *et al*., 1998: 1148) and economic growth (Mahoney, 2001), both transition and emerging economies opt for statute law for creating the legal basis of such markets, following to some extent the model of developed economies, which for many decades has been based on statutes.

In line with this interpretation, our analysis does not advise any specific reform agenda for transition and developing economies in general but instead suggests that institutional development and academic research should aim at identifying the contextual circumstances which affect the costs and benefits of the different solutions. In some cases, the problems of these economies may be more similar to those faced on the Continent at the demise of the ancient regime than to those enjoyed by England more or less at the same time. If so, restraining judicial discretion may now be necessary in developing economies in order to guarantee freedom of contract.

In addition to the obvious need for adaptation, our work suggests that the creation of market-friendly institutions in transition and developing economies would benefit from examining the presence or absence of a cognitive gap in understanding how markets work, similar to the one alleged between European legislators and judges in the 19th century. The lack of forward-

looking, market-wise judges can be safely assumed in many transition and developing economies. The existence of elites having a clear idea of market relations and their systemic effects probably does not vary substantially among countries. However, the role of these elites in government differs with the nature of the political system. Such elites may be allowed to lead the transition (as in some cases in Asia) or, on the contrary, they might be sidestepped by governments acting as mere political agents of ill-informed voters (as, for instance, in much of Latin America).

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